

CREDIT OPINION

15 June 2017

Update

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RATINGS

East Rand Water Care Company

Domicile	South Africa
Long Term Rating	Ba1
Type	LT Issuer Rating - Dom Curr
Outlook	Negative

Please see the ratings section at the end of this report for more information. The ratings and outlook shown reflect information as of the publication date.

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East Rand Water Care Company

Update Following Sovereign Action

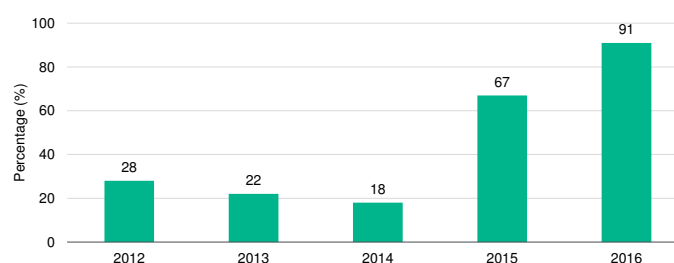
Summary Rating Rationale

The Ba1/Aa3.za global and national scale long-term issuer ratings of East Rand Water Care Company (ERWAT) reflect its close financial and operational links with its support provider, Ekurhuleni Metropolitan Municipality (Baa3/Aaa.za), which guaranteed 92% of the company's debt as at 31 June 2016. ERWAT ratings are also supported by the company's legal status as a public-sector entity. ERWAT operates under a clear public policy mandate from Ekurhuleni Metropolitan Municipality. The ratings also reflect its adequate financial performance and history of satisfactory budgetary results.

Very high debt level, albeit in line with ERWAT's sizeable capital expenditure plan

Exhibit 1

Net Direct and Indirect Debt/Operating Revenue (%)



Source: Moody's Investors Service

Credit Strengths

- » High degree of support and supervision from Ekurhuleni Metropolitan Municipality
- » Close integration with Ekurhuleni, which also guarantees most of ERWAT's debt
- » Public legal status
- » Satisfactory financial performance
- » Relatively conservative governance and management
- » Strong liquidity profile

Credit Challenges

- » Very high debt level, in line with intensive capital investments
- » Limited prospects for business diversification and expansion

Rating Outlook

- » The negative outlook on ERWAT's rating mirrors the action taken on the rating of its support provider, Ekurhuleni Metropolitan Municipality (Baa3/P-3 NEG).

Factors that Could Lead to an Upgrade

- » A stabilisation of ERWAT's outlook would first require the same change in the outlook of its support provider, Ekurhuleni Metropolitan Municipality.
- » An upgrade of ERWAT's rating would require an upgrade in the rating of its parent municipality.

Factors that Could Lead to a Downgrade

- » Any indication of weakening in Ekurhuleni's willingness to support ERWAT would likely lead to a downgrade.
- » In addition, a downgrade of Ekurhuleni's rating would require a corresponding change in ERWAT's rating.

Key Indicators

Exhibit 2

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Key Indicators

East Rand Water Care Company, (ERWAT)

	2012	2013	2014	2015	2016
Total Assets (ZARmillion)	1,042.9	1,207.7	1,347.6	1,737.5	2,143.1
Operating margin (%)	42%	36%	35%	32%	32%
Surplus (Deficit) for the Year / Total income (%)	28%	20%	21%	13%	12%
Total Debt / Total Assets (%)	13%	10%	8%	23%	30%
Debt / Cash flow from operations (x)	0.7	0.8	1.8	35.9	8.1
Cash interest cover ratio (x) [1]	17.8	17.2	5.9	0.7	1.7
Current Assets / Current Liabilities (x)	2.7	2.0	0.6	2.3	2.4

Source: Moody's Investors Service

Recent Developments

On 12 June 2017, Moody's downgraded by one notch the global scale ratings of three Government Related Issuer (GRIs), including ERWAT's to Ba1 global scale local issuer rating and changed the outlook to negative. The decision mirrors the action taken on the rating of its support provider, Ekurhuleni Metropolitan Municipality (Baa3/P-3 NEG). reflects the close operational and financial linkages between the national government and state-owned entities and follows the weakening of the South African government's credit profile, as captured by Moody's similar rating action on the sovereign rating on 9 June 2017.

At the same time Moody's affirmed ERWAT's long term and short term national scale issuer ratings of Aa3.za in line with the new National Scale Rating Mapping tables.

This publication does not announce a credit rating action. For any credit ratings referenced in this publication, please see the ratings tab on the issuer/entity page on www.moody's.com for the most updated credit rating action information and rating history.

Detailed Rating Considerations

High degree of support and supervision from Ekurhuleni Metropolitan Municipality

Moody's considers ERWAT to be a government related issuer. From a credit risk perspective, it is not meaningful to distinguish between ERWAT and Ekurhuleni Metropolitan Municipality because of the intrinsic operational and financial ties between the two. As such, ERWAT's rating derives from the application of the approach for GRIs rated solely on support, as described in Moody's rating methodology for GRIs entitled "[Government Related Issuers: Methodology Update](#)" published in October 2014. We placed ERWAT's rating at one notch below that of its support provider to reflect the fact that ERWAT's debt not being fully guaranteed and Ekurhuleni having other state-owned entities under its control.

Close integration with Ekurhuleni, which also guarantees most of ERWAT's debt

ERWAT's management structure and governance clearly indicate strong control by Ekurhuleni Metropolitan Municipality, which owns 97% of the entity's shares. ERWAT derives 75% of its total revenue from service charges collected by Ekurhuleni Metropolitan Municipality and transferred to ERWAT in equal monthly installments, ensuring regular cash flow. A further 11% of ERWAT's total revenue is derived from capital grants. Other income such as laboratory services contribute 14% to total revenue. ERWAT's capital expansion and borrowing plans are approved by Ekurhuleni. As at 30 June 2016, 92% of ERWAT's total debt exposure benefited from explicit guarantees from its municipal shareholder. ERWAT's budget and borrowing plans are approved by the support provider.

Public legal status

ERWAT is a public company, majority-owned by the metropolitan municipality of Ekurhuleni. Its profile is also underpinned by the company's public legal status as a "municipal entity" under the Municipal Finance Management Act. Furthermore, the rating incorporates its monopolistic status as the only wastewater treatment company for Ekurhuleni Metropolitan Municipality, its majority shareholder, as well as its strategic role and close financial linkages with, the metropolitan municipality. ERWAT provides bulk wastewater conveyance and wastewater treatment services to some 2,000 industries and more than 3.2 million people predominantly in the metropolitan area of Ekurhuleni. It operates the area's 19 waste water treatment plants within the shareholder's area of jurisdiction.

Satisfactory financial performance

ERWAT's total revenue increased by 18% to ZAR789 million (\$51 million) in the fiscal year ending June 2016, compared with a 6% rise in the previous fiscal year, this was largely due to an increase in government grants and other income. ERWAT derives the vast majority (75%) of its total revenue from service charges for wastewater sewerage in the metropolitan area of Ekurhuleni. The company determines its service charges through negotiations with the municipal administration. The support provider is responsible for revenue collection from users, which it redistributes to ERWAT in equal monthly installments, thereby providing stability to the company's cash flows. ERWAT accrues other income from service agreements with private clients outside of its jurisdiction. This business line, which contributes 14% of the company's total income, includes laboratory services and research and development for other public sector entities.

ERWAT's revenue structure is well established and, in our opinion, prospects are limited for any shift in its business model that could affect its revenue structure. It is also unlikely that ERWAT's monopolistic status as the sole provider of a municipal statutory service will change in the medium term. ERWAT operates under a very rigid cost structure, with major expenditure items such as staff costs and bulk purchases decided at the support level. These costs, which offer limited expenditure flexibility, accounted for 63% of operating expenditure in 2016.

Relatively conservative governance and management

ERWAT's administration system is a reflection of its relatively conservative financial management. The parent municipality exercises oversight over both the company's strategic direction and compliance when it comes to financial governance and reporting. Ekurhuleni does this through (1) appointing ERWAT's board members and having two of its members serve as observers; and (2) performing the company's internal audit.

Strong liquidity profile

In the past few years, ERWAT largely funded its capital expansion from own funds and capital grants, resulting in a weaker liquidity profile. As a result, the entity recorded its weakest liquidity ratio of 0.6x in 2014. However, ERWAT's liquidity position substantially

improved to 2.4x as at 30 June 2016 after the approval of ZAR550 million in loan which was used to finance its large capital investment of ZAR548 million over the fiscal years ending in 2015 and 2016. ERWAT's cash and cash equivalent improved to ZAR305 million as at 30 June 2016 from ZAR87 million the previous year.

Very high debt levels, albeit in line with intensive capital investment

ERWAT's reported debt stock of ZAR633 million represented a very high 91% of operating revenue at 30 June 2016. We expect the entity's debt stock to remain high because ERWAT intends to increase borrowing in the medium term. The entity's debt level is, however, in line with our expectations. We regard ERWAT's debt levels as very high compared with the company's annual budget volumes, though the entity remains supported by its municipal shareholder through the guarantee provided by Ekurhuleni Metropolitan Municipality to cover debt incurred by its owned entities. The guaranteed debt of ZAR550 million is an indication of the municipality's absolute backing of investments that it considers strategic to its objectives. We have factored both the proposed debt and the guarantee into ERWAT's rating. ERWAT has identified capital infrastructure requirements of ZAR1.1 billion for fiscal years ending 2017 and 2018 which, once approved, will be funded entirely from capital grants and guaranteed debt.

Limited prospects for business diversification and expansion

ERWAT is 97% owned by the metropolitan municipality of Ekurhuleni, with the remaining 3% divided equally between the City of Johannesburg and Lesedi Local Municipality. As such, its operating area is within its major shareholder's boundaries, and the company has very little to no prospect of expanding its core business operations outside Ekurhuleni's borders, except for a small portion of research and laboratory services performed on behalf of other industries and government entities. The company, which does not pursue profit as a business objective and is tax exempt, operates under a mandate from its major shareholder and is governed by the Municipal Finance Management Act. Ekurhuleni municipality is responsible for setting ERWAT's wastewater services tariffs and the municipality exercises strong control and oversight over the company's strategy, annual budgets and cash flows. ERWAT is the largest governmental entity that Ekurhuleni owns and the municipality recognises the company plays a crucial role in fulfilling one of its statutory responsibilities. Thus, the facilities under ERWAT operations form an integral part of the metropolitan municipality's infrastructure network. We understand that there is no political will to privatise ERWAT.

Rating Methodology and Scorecard Factors

In our assessment of ERWAT's credit profile, we apply our global rating methodology for Government-Related Issuers, published in October 2014. Please see the Credit Policy page on www.moody's.com for a copy of these methodologies.

Ratings

Exhibit 3

Category	Moody's Rating
EAST RAND WATER CARE COMPANY	
Outlook	Negative
Issuer Rating -Dom Curr	Ba1
NSR Issuer Rating	Aa3.za

Source: Moody's Investors Service

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REPORT NUMBER

1077024